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SUBJECT: Views from Frankfurt on German Banking Regulation and Supervision in the Wake of the Subprime Turmoil

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¶1. SUMMARY. Following months of global financial turmoil, German banking regulators have taken steps to harmonize and standardize their practices. At the same time, Germany's Finance Minister has become more vocal in criticizing the current regulatory system, calling for higher capital requirements for banks. CG Frankfurt Econ Off and Econ Spec met with Frankfurt-based banking officials and executives to discuss views on tighter regulation, finding general consensus that the recent demarcation of powers between regulatory agencies was a positive development. On the other hand, reactions to Finance Minister Steinbrueck's call for more action are skeptical. Few believe that EU member states will cede supervisory authority to the European Union, and will instead continue working towards greater coordination and convergence. END SUMMARY.

BUNDESBANK AND BAFIN DEFINE COMPETENCIES

¶2. The February 5 agreement between Germany's central bank, the Bundesbank, and its financial supervisor, the Federal Financial Supervisory Authority (BaFin), ended a long-standing debate over areas of responsibility between the two (reftel a). Officials at the Bundesbank said they welcomed the agreement because it further ensured the institution's long-standing reputation as Europe's most independent central bank. The agreement leaves the Bundesbank firmly in charge of everyday monitoring, while BaFin will assumes a coordinating role (i.e. banking supervision, sanctions, policy-making), including interacting with the Finance Ministry on rule-making. The Bundesbank can now focus on its main duties: maintaining stability and acting as a lender of last resort.

¶3. Private bankers have responded favorably to the agreement noting that by eliminating duplication, the two bodies will save on reporting costs. An executive at Deutsche Bank pointed to the significant cost savings for smaller banks, resulting from fewer BaFin special audits. An executive at Helaba said that leaving day-to-day oversight with the Bundesbank "made sense" due to the Bundesbank's location in Frankfurt -- Germany's financial capital. Opinions varied on which supervisory institution benefited most from the recent agreement, with some contacts noting that BaFin, as the regulatory authority, had won the real power and others commenting that Bundesbank, now firmly responsible for day-to-day auditing, had most of the work. Most agreed, however, that the new agreement was more efficient and made sense.

STEINBRUECK'S CALL FOR ACTION GETS LUKEWARM RESPONSE

¶4. Both before and during the recent G-7 Finance Minister meeting in Tokyo, German Finance Minister Peer Steinbrueck responded to global financial turmoil, calling for Germany to tighten banking regulation by raising capital requirements 2% over Basel II guidelines, if necessary unilaterally (reftel b). With Basel II only having gone into effect on January 1, 2008, Bundesbank officials cautioned against premature conclusions. Moreover, they criticized Steinbrueck's proposal as unnecessary, since most banks already exceed the minimum requirement.

¶5. Officials at the European Central Bank (ECB) speculated that Steinbrueck's proposal could be a back door to his goal of achieving furthering bank consolidation. (Note: raising capital requirements would disproportionately impact small banks.) They questioned whether such a requirement would run counter to the European Union's stated goal of maintaining a level playing field in the banking sector. Several sources pointed out that Steinbrueck's call had failed to address the real root of financial turmoil: special investment vehicles and conduits that operated off balance sheets, had no capital requirements, and had to be rescued by large liquidity injections once the commercial paper market dried up.

TOWARDS AN EVER CLOSER UNION?

¶6. Officials at the Bundesbank and the ECB agreed that European supervisory bodies needed to move toward greater standardization, but that a single European Union supervisory authority was unlikely, even in the long run. The lack of common reporting standards among eurozone members creates difficulties for the ECB, which makes decisions on the basis of different methodologies that can not be properly compared. ECB officials pointed out that since 2003 member states have slowly moved towards convergence through the so-named Lamfalussy framework and greater cooperation has been achieved through the Committee of European Banking Supervisors. They further argued that, even if the political will existed, the EU would need to take on law-making authority and revise the union treaty, both of

which were unlikely.

¶7. COMMENT. As the full extent of the damage to the German banking industry caused by the subprime crisis unfolds in 2008, the debate on banking regulation will continue with officials and politicians looking to ward off the next crisis. While the system has, for the most part, responded well, experts here intend to keep a close eye on the implementation of Basel II reforms and on how BaFin and the Bundesbank adjust to their more clearly defined roles. Perhaps the most critical question will be how politicians react if more banks fail and the public outcry increases. END COMMENT.

¶8. This cable was coordinated with Embassy Berlin and CG DUESSELDORF.
POWELL